Europe Economics

# Review of the Industry Risk Fund and Network Rail Fee Fund

## Executive Summary

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# 1 Executive Summary

This report by Europe Economics, commissioned by the Office of Rail and Road (ORR), reviews the Industry Risk Fund (IRF) and Network Rail Fee Fund (NRFF). The review considers how the funds are structured, financed, and governed, and whether they provide proportionate cover, operate transparently, and support investment incentives.

### Background and Methodology

The IRF and the NRFF are central features of the Rail Network Investment Framework (RNIF). They were established to provide third-party promoters with protection against defined liabilities when investing in enhancements on the national rail network. The NRFF covers liabilities that arise from Network Rail's own actions, such as breach of contract or negligence, while the IRF covers low-probability but high-impact risks affecting the wider industry, such as legislative or safety changes beyond the control of individual projects. Since 2006, the funds have supported around 3,500 projects.

This review assesses whether the funds continue to serve their intended role and whether they support or hinder investment. The analysis draws on financial data and documentation from Network Rail and ORR, comparisons with the Arup review, the findings from ORR's Phase 1 review of the RNIF, and lessons from similar mechanisms in other regulated sectors. The evidence base has some gaps – for example, there is limited information on agreement-level contributions or current investor perspectives – but the available information provides a basis for examining contribution levels, governance, transparency, and incentive effects.

### Comparator Mechanisms

We examined three comparator schemes from other regulated sectors: the California Wildfire Fund, Flood Re, and Ofgem's Strategic Innovation Fund. While designed for different purposes, they share governance and financial features that provide lessons for the rail funds.

California Wildfire Fund. Established in 2019 with a value of $21bn, the fund was designed to stabilise California's investor-owned utilities by covering liabilities from utility-caused wildfires. Oversight is provided by the California Catastrophe Response Council, a dedicated public body made up of state officials and independent members, while the California Earthquake Authority manages day-to-day administration. The fund's assets are ring-fenced in law and invested in safe, liquid instruments, with all returns credited back to the fund. It publishes audited accounts, agendas, and minutes of council meetings. Claims are reimbursed within 45 days, with a subsequent prudence review to confirm the appropriateness of payments.

Flood Re. Introduced in 2016, Flood Re is a statutory reinsurance pool that supports affordable household flood insurance for high-risk properties. It is operated by Flood Re Ltd, with a board including both independent and industry non-executives. It produces audited annual reports and is subject to a statutory five-year review, providing regular external scrutiny. Funding is ring-fenced by law and collected through levies on insurers and fixed premiums for ceded policies. Claims are processed through insurers and reimbursed promptly, and disputes are managed through a standing technical committee.

Strategic Innovation Fund. Ofgem's Strategic Innovation Fund (SIF) supports innovation projects in Britain's energy networks. It is funded through regulated consumer charges and administered in partnership with Innovate UK. Ofgem sets the policy framework and makes final decisions, while Innovate UK manages competitions and monitors projects, using independent assessors. Ofgem and Innovate UK publish funding decisions, project directions, and reports on underspends, with unspent money returned to consumers.

Common lessons. The comparator schemes show a range of design features that strengthen credibility and effectiveness. Across them we observe:

- Independent oversight. External bodies play a role in governance, whether through statutory councils, government frameworks, or regulatory panels.
- Transparency. Audited accounts and reports are published, providing visibility of balances and performance.
- Service standards. In some cases, specified timeframes for claims or reimbursements give contributors predictability on timing.
- Ring-fenced resources. Contributions are kept separate, with returns credited back to the fund.
- Regular review. Periodic external reviews help ensure arrangements remain proportionate and effective.

## Key Findings

Our review shows that the risk funds have provided protection to third-party promoters, but several features of their current design and operation limit their effectiveness and credibility.

### Contribution rates and headroom

The risk funds have accumulated substantial surpluses, as contributions from promoters have consistently exceeded the value of claims paid. Even after allowing for potential claims not yet settled, there remain significant unused balances. This pattern reflects contributions being set above the level of payouts that have materialised so far, particularly for the IRF. The payout ratios for some types of template agreement are close to zero, meaning contributions have been collected but rarely used for payouts. Other types of template agreement have seen claims exceed contributions. In practice, this creates cross-subsidies: some promoters pay materially more than their exposure warrants, while others are shielded from the full cost of their liabilities. Without reform, these imbalances may persist, undermining confidence in whether contribution levels are proportionate.

### £50 million threshold

The threshold for applying ORR-approved template agreements was set at £50 million in 2005 and has never been updated. If the threshold had been updated in line with inflation since 2005, it would now be £87 million – meaning that the value of the threshold has fallen significantly through time in real terms. The result is that more projects may fall outside the scope of the protections offered to third-party promoters through regulator-approved template agreements. In 2023/24, only two new agreements were entered into that exceeded £50 million, but as costs rise more projects may fall outside template cover over time. This risks leaving promoters with weaker bargaining positions and inconsistent contractual protections, contrary to the original intent of the framework. Unless corrected by an uplift and indexation, the real value of the threshold will continue to drift downwards, steadily reducing the protections available to investors.

### Interest on balances

Contributions to the IRF and NRFF are placed in Network Rail's government bank account, albeit recorded under separate ledger codes. As a result, the funds do not accrue interest. Instead, interest on the overall balance in Network Rail's bank account is used to reduce the grant for interest costs that Network Rail receives from the Department for Transport. Our analysis indicates that had balances been credited with interest, the headroom would be materially higher than it is today. In recent years the missed interest has represented a large share of new contributions. This treatment imposes an opportunity cost on promoters: their funds are tied up without return, requiring higher contribution rates to sustain headroom. It also runs counter to good practice followed by one of the comparator schemes (the California Wildfire Fund), in which contributions are ring-fenced and invested in safe, liquid assets, with all returns accruing to the fund itself.

### Governance and transparency

The funds are managed entirely within Network Rail. Contributions are paid into its bank account, and decisions on claims are made by its internal governance structures, with final authorisation resting with Network Rail's Investment Panel. While annual statements are provided to ORR, these are not published, and decisions about contribution levels are taken by Network Rail rather than an independent body. This lack of transparency fuels misconceptions – for example, that promoters "own" a pot corresponding to their contributions – and undermines confidence in whether funds are being managed appropriately. By contrast, comparator schemes in other sectors publish audited accounts and operate under independent boards, reinforcing accountability and legitimacy.

### Speed of claims processing

The absence of defined service standards for claims processing was identified as a weakness in the previous Arup review. Claims can take many months or even years to resolve. An example is a claim that took several years to reach settlement. Promoters have no assurance over how long a claim will take or when they will receive reimbursement, creating financial uncertainty and potential cashflow pressures. These weaknesses could raise financing costs and potentially deter third-party investment, particularly for promoters with limited financial resilience.

The lack of mediation or alternative dispute resolution mechanisms in contract templates may further compound delays, potentially leaving promoters reliant on protracted internal processes within Network Rail or formal adjudication. We note that disputes under the Investment Framework, including those relating to the risk funds, can ultimately be referred to ORR. However, the fact that this escalation route is available for disputes relating to the risk funds has not been highlighted to third-party investors, and we understand that it has not been used to date.

## Recommendations

Our review suggests that the funds continue to have a role to play in principle, but that they require reform to ensure that they are proportionate, transparent, and effective in supporting investment.

### Independent review of contributions

Contribution rates have been set at Network Rail's discretion and contributions have significantly exceeded payouts, creating uncertainty over whether charges are proportionate. We recommend introducing independent actuarial oversight of contribution levels, with contribution rates recalibrated every two or three years by an independent actuary. An actuary could analyse claims history and model expected liabilities by contract type. This would create an objective basis for setting contribution rates, reduce unnecessary headroom, and ensure that promoters are not paying materially more than their risk exposure warrants.

### Update the £50 million threshold

The threshold has not been updated since 2005, so its real value has nearly halved, narrowing the scope of template protections. We recommend a two-part reform: first, a one-off uplift to restore the threshold to its original real value (around £85–90 million in today's prices); and second, annual indexation to CPI to prevent further erosion of the real value of the threshold. This would preserve the intended balance between regulated, standardised contracts for mid-sized projects and bespoke terms for the largest schemes.

### Financial ring-fence and interest on balances

Promoter contributions are currently held under ledger codes within Network Rail's central account, meaning they are not ring-fenced and do not generate returns. To address this, we recommend reforming how the funds are held. In the short term, the ideal approach would be for Network Rail to operate a dedicated bank account for the risk funds, with balances ring-fenced and credited with interest. If Treasury rules prevent this, ORR may want to consider whether an independent body should be established to manage the funds. This would allow returns to accrue directly to the funds, although it would also involve initial set up and ongoing running costs and could create perverse incentives for Network Rail (see discussion below of setting up an independent body). Crediting the interest from fund balances back to the funds themselves would align with good practice from comparator mechanisms and would reduce the contribution burden on promoters over time.

### Strengthen governance and transparency

The funds are managed entirely within Network Rail, with annual statements provided only to ORR and no independent oversight or published accounts, leaving promoters with little visibility or assurance. We therefore recommend that the governance of the risk funds is strengthened. In particular, we recommend requiring the publication of annual audited reports, building on the existing annual headroom report currently provided to the ORR. These reports should cover contributions, drawdowns, and headroom, alongside performance against service standards (discussed below).

We also considered whether there was a case for setting up an independent body to oversee the funds. However, this would carry a risk of creating perverse incentives for Network Rail: if the costs of disruption to third-party projects were borne by an external fund rather than Network Rail itself, the company might have less incentive to minimise such events. While similar mechanisms in other sectors manage this risk through an "excess" (as in Flood Re and the California Wildfire Fund), this approach would not be feasible here, as Network Rail has no independent funding source beyond the fee funds themselves to bear such an excess.

### Introduce service standards

The case studies and evidence from the previous Arup review indicate that claims under the risk funds can take a long time to resolve, with some cases taking years to conclude. This undermines confidence and creates cashflow pressures. We recommend that ORR establish clear service standards for the rail risk funds, including maximum time limits for acknowledging claims, reaching decisions, and making payments. These would apply only to third party claims, not to Network Rail's internal processes, and accountability for meeting them should rest with Network Rail as the fund administrator. These should be accompanied by published performance metrics, so contributors can see whether targets are being met.

To further reduce delays, an alternative dispute resolution mechanism, such as independent mediation, should be embedded in the contract templates so that it becomes a binding step in the process if a dispute arises. This would also give third-party promoters assurance that independent input into claims handling will occur without needing to resort to statutory adjudication. If ADR remains outside the templates, it can only proceed by mutual agreement, which offers less certainty. The fact that disputes relating to the risk funds can be appealed to the ORR should also be highlighted to third-party investors.

### Periodic review of overall design

The funds have only been adjusted in piecemeal ways, allowing growing surpluses, slow claims handling, and limited transparency to persist. We recommend establishing a structured cycle of independent reviews of the funds' overall design and performance. In the short term, reviews could be carried out every two to three years by ORR or DfT, examining whether the funds remain proportionate, transparent, and effective in supporting investment. Over the longer term, if an independent body is set up to oversee the funds, a five-year review cycle may be sufficient, in line with good practice in comparator schemes such as Flood Re.